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Supreme Court, U. S.
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In the

Supreme Court of the United States

OCTOBER TERM, 1974

ERNST & ERNST, *Petitioner,*

vs.

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

vs.

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR RESPONDENTS, Olga Hochfelder, Et Al.

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BRIEF FOR RESPONDENTS, Olga Hochfelder, Et Al.

STATEMENT OF THE CASE

In 1968 Leston B. Nay, the president of First Securities Company of Chicago, a broker-dealer in securities, murdered his wife and killed himself. He left a suicide letter in which he said that his company was bankrupt because of his thefts dating from 1938 (A 396-401). His suicide

note also said that certain escrows which he had made were spurious (A 396-401). The plaintiffs had invested their life savings in those spurious escrows. A succinct and accurate statement of the background facts in this case is given in the prior case of *SEC* v. *First Securities Co.*, 463 F.2d 981, 983 (1972).

Ernst & Ernst ("Ernst") selects from this statement of the Court of Appeals the facts supporting its theories and omits the facts militating against them. Thus, Ernst fails to state that the plaintiffs had been customers of First Securties Co., buying and selling securities in regular fashion, (p. 983). Ernst fails to state that Nay made the proposal of the fictitious escrow to plaintiffs in the office of the company, (p. 983). Actually this proposal was made under a large plaque, stating in big type that Leston B. Nay had been made a member of the Midwest Stock Exchange where "high standards of commercial honor and integrity are maintained." (A 5, 226) That plaque was kept there only through Ernst's audits. Ernst fails to state that Nay persuaded these victims to sell their regular securities through First Securities Company in order to secure the funds to invest in the fictitious escrow (p. 983). Ernst fails to state that every letter that Nay wrote these victims bore the words "Member Midwest Stock Exchange" (p. 983). Ernst fails to state that Nay's victims received their purported payment of interest on the fictitious escrow in envelopes of First Securities Company (p. 983). Ernst fails to state that when, at the end, one of his victims asked to withdraw his investment in the escrow, Nay said to him, "Your money is safe at First Securities." (A 984) By these omissions from the Court of Appeals statement of the background facts, Ernst seeks to show that plaintiffs dealt with Nay personally

rather than with First Securities Company. If so, they did not know it.

Ernst fails to state the crucial fact in the case: "Nay had forbidden anyone other than himself to open mail addressed to him and in his absence all such mail was simply allowed to pile up on his desk, even if it was addressed to First Securities for his attention." (p. 984) The great mass of his correspondence with his escrow victims was found, on his death, locked in his desk. Ernst states "Nay took vacations regularly." On the contrary, its affiant for summary judgment, Campbell (A 96-102) scrupulously avoids stating that Nay took "regular vacations" and two of the plaintiffs swore, in answer to interrogatories, that Nay's vacations were short, irregular and were often postponed. He could not leave the office when there was a possibility that his colossal fraud might be discovered. (See Infra. pp. 24-5).

Each year for 20 years (1947-1967) Ernst had certified to Midwest Stock Exchange a financial statement of First Securities Company showing it to be solvent when, in fact, it was wholly insolvent (A 179-228, 398). Each year Ernst certified to Midwest Stock Exchange that it had reviewed the internal accounting control of First Securities Company (A. 181-182, 185-187, 188-190, 197, 201-203). Actually the Company had no internal accounting control because of Nay's mail rule and Ernst had not reviewed its internal accounting control. (Infra. pp. 13-14, 21).

I.

SUMMARY JUDGMENT CANNOT BE GRANTED WHERE THERE IS A "HEAD-ON FACTUAL CONTROVERSY."

The sole issue in this case is whether summary judgment may be granted to Ernst. The guaranty of jury trial in the Seventh Amendment precludes a summary judgment in all but a few cases. We find 19 cases where this Court has reversed a summary judgment.[1] To give Ernst a summary judgment here, this Court would have to overrule some of those 19 cases. In no case, comparable to this has this Court granted a summary judgment.[2]

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[1] *Sartor* v. *Arkansas Natural Gas Corp.*, 321 U. S. 620 (1944); *Elder* v. *Brannan*, 341 U. S. 277 (1951); *United States* v. *Western Pacific Railroad Co., et al.*, 352 U. S. 59 (1956); *Poller* v. *Columbia Broadcasting System, Inc.*, 368 U. S. 464 (1962); *United States* v. *Diebold, Inc.*, 369 U. S. 654 (1962); *Free* v. *Bland*, 369 U. S. 663 (1962); *White Motor Co.* v. *United States*, 372 U. S. 253 (1963); *Simpson* v. *Union Oil Co.*, 377 U. S. 13 (1964); *Dombrowski* v. *Eastland*, 387 U. S. 82 (1967); *Perma Mufflers* v. *Int. Parts Corp.*, 302 U. S. 134 (1968); *Fortner, Inc.* v. *United States Steel Corporation*, 394 U. S. 495 (1969); *Norfolk Monument Co.* v. *Woodlawn*, 394 U. S. 700 (1969); *Adickes* v. *Kress & Co.*, 398 U. S. 144 (1970); *Phillips* v. *Martin Marietta Corp.*, 400 U. S. 542 (1971); *Askew* v. *Hargrave*, 401 U. S. 476 (1971); *Carter* v. *Stanton*, 405 U. S. 669 (1972); *Board of Regents* v. *Roth*, 408 U. S. 564 (1972); *Perry* v. *Sindermann*, 408 U. S. 593 (1972); *Hurtado* v. *U. S.*, 410 U. S. 578 (1973).

[2] The following are the only cases where this Court has affirmed a summary judgment: *Associated Press* v. *United States*, 326 U. S. 1 (1944); *Citizens Publishing Co.* v. *United States*, 394 U. S. 131 (1969) per se violations by document of antitrust laws; *United States* v. *W. T. Grant Co.*, 345 U. S. 629 (1953); No genuine issue as to

In the much cited *Per Curiam* opinion of *United States* v. *Diebold*, 369 U. S. 654, 655 (1962), this Court held that where the materials before the Court showed a "head-on factual controversy", no summary judgment could be granted. Here there were directly conflicting affidavits of Public Accountants on whether an Accountant could certify a financial statement under the circumstances of Nay's mail rule (A 168-176; 102-116). Clearly, a summary judgment to Ernst in this case would overrule *Diebold*. In that case, this Court unanimously declared: "On summary judgment, the inferences to be drawn from the underlying facts contained in such materials [before the court] must be viewed in the light most favorable to the party opposing the motion."

Another leading case reversing a summary judgment that this Court would have to overrule in granting a summary judgment here is *Adickes* v. *Kress & Co.*, 398 U. S. 144 (1970). This Court said "As the moving party, respondent had the burden of showing the *absence of a genuine issue as to any material fact*, and for these purposes the material it lodged must be viewed in the light most favorable to the opposing party. Respondent did not carry its burden because of its failure to foreclose the *possibility* that there was a policeman in the Kress store

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[2] (Continued)
any material fact where interlocking directors of competing corporations had resigned; *First National Bank* v. *Cities Service Co.*, 391 U. S. 253 (1968); No longer any genuine issue of material fact in treble damage antitrust suit after 10 years of depositions; *Weinberger* v. *Hynson*, 412 U. S. 609 (1973); Suit for declaratory judgment not involving jury requirement; *Mourning* v. *Family Publications Service*, 411 U. S. 356 (1973). Both litigants admitted no genuine issue of material fact.

while petitioner was awaiting service. . . ." (p. 157, Emphasis supplied) In the same case, Justice Black concurring said:

> "'The right to confront, cross-examine and impeach adverse witnesses is one of the most fundamental rights sought to be preserved by the Seventh Amendment provision for jury trials in civil cases. The advantages of trial before a live jury with live witnesses, and all the possibilities of consisdering the human factors, should not be eliminated by substituting trial by affidavit and the sterile bareness of summary judgment." (p. 176).

This Court, in reversing a summary judgment, in *Poller* v. *Columbia Broadcasting*, 368 U. S. 464, 473 (1962), said:

> "It is only when the witnesses are present and subject to cross examination that their credibility and the weight to be given their testimony can be appraised. Trial by affidavit is no substitute for trial by jury which so long has been the hallmark of 'even handed justice.'"

In reversing a summary judgment for the United States in an antitrust case, this Court declared that summary judgment is not "appropriate where motive and intent play leading roles." *White Motor Co.* v. *United States*, 372 U. S. 253, 259 (1963). How much more inappropriate is summary judgment where, as here, the line between a public accountant's non-liability or liability, is between "mere negligence" and "gross negligence".

Again in the case of *Norfolk Monument Co.* v. *Woodlawn Memorial Gardens*, 394 U. S. 700, (1969), this Court *Per Curiam* granted certiorari and simultaneously reversed a summary judgment against a plaintiff in a private antitrust suit charging conspiracy. This Court

said (p. 701): "We cannot agree that . . . a jury *could not* have found that the respondents had conspired to exclude the petitioner from . . . the market for bronze grave markers" (Emphasis supplied). This Court also said (p. 704) that the "alleged conspiracy had not been *conclusively* disproved by pre-trial discovery" (Emphasis supplied). We submit that this Court would have to overrule that case to grant summary judgment to Ernst here. Under the express terms of Rule 56 it is only where "there is no genuine issue as to *any* material fact" that summary judgment can be granted (Emphasis supplied).

This Court, in its first summary judgment case of *Sartor* v. *Arkansas Natural Gas Corporation*, 321 U. S. 620, 627, (1944), declared, in reversing, that summary judgment cannot be granted upon the opinion affidavits of expert witnesses, even though they are not met by counter affidavits since, under the Seventh Amendment, the opposing party is entitled to cross-examine such witnesses. Four of Ernst's six affidavits here are such expert opinion affidavits of C.P.A.s (A 102-140, 148-153). The plaintiffs attempted to take the depositions of Ernst's affiants but its attorneys instructed them not to answer many pertinent questions (A 184, 185, 189, 200, 205, 208, 209, 210, 211, 212, 218, 219, 221, 222, 224, 226, 227, 360, 361, 363, 364, 366, 368, 370). Furthermore, the plaintiffs here filed affidavits of distinguished experts, directly controverting Ernst's expert affiants (A 168-178).

The complaint in this case followed the form of Count III of the complaint in *Buttrey* v. *Merrill Lynch*, 410 F.2d 135 (1969) *cert. den.* 396 U. S. 838. There, Dobitch, a broker, who had defrauded his customers of a vast amount, used the proceeds of his fraud in speculation

with Merrill Lynch. That company failed to comply with the rule of the New York Stock Exchange requiring it to investigate its customers. The complaint charged that it had aided and abetted Dobitch's fraud in violation of Section 10 and Rule 10b-5 by such non-compliance with the New York Stock Exchange rule. The complaint charged as here that Merrill Lynch knew or should have known of Dobitch's fraud. It would have known of the fraud if it had done its duty under the rule of the New York Stock Exchange. The District Court and the Court of Appeals denied summary judgment and this Court denied certiorari from that denial. It is clear that the officers of Merrill Lynch did not actually know of Dobitch's fraud. If they had actually known of it, they would not, in common sense, have accepted Dobitch as a customer. But if Merrill Lynch had complied with the rule of the New York Stock Exchange requiring it to investigate its customers, it would have known of Dobitch's fraud. The complaint here charged that Ernst aided and abetted Nay's admitted violation of Section 10 and Rule 10b-5 by violation of its professional duty as a Public Accountant. If it had performed that duty it would have discovered Nay's fraud and would not have issued its false certifications.

The Seventh Circuit Court of Appeals has in four cases applied the rule that a defendant is civilly liable for aiding and abetting a violation of Section 10 and Rule 10b-5. In each such case this Court has denied certiorari. *Brennan* v. *Midwestern Life Ins. Co.*, 417 F.2d 147, (1969), *cert. den.* 397 U. S. 989; *Buttrey* v. *Merrill Lynch*, 410 F.2d 135, (1969), *cert. den.* 396 U. S. 838; *Securities & Exchange Comm.* v. *First Securities Co.*, 463 F.2d 981, (1972), *cert. den.* 409 U. S. 880; *Securities & Exchange*

Comm. v. *First Securities Co.*, 466 F.2d 1035 (1972), *cert. den.* 409 U. S. 1041.

These cases were based upon ¶(c) of Rule 876 of the Restatement of the Law of Torts:

> "For harm resulting to a third person from the tortious conduct of another, a person is liable, if he
>
> • • •
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.[3]

These aiding and abetting cases are the products of the repeated commands of this Court that when a violation of the securities Acts has occurred ". . . it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *J. I. Case Co.* v. *Borak*, 377 U. S. 426, at 433 (1964); *Mills* v. *Electric Auto Lite Co.*, 396 U. S. 375 at 386 (1970).

No one could deny that Nay violated the Securities Acts.

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[3] "The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statement which he certifies . . . His duty is to safeguard the public interest, not that of his client." (SEC Accounting Release No. 78, March 25, 1957, 4 CCH Fed. Sec. Law Rep. ¶ 72 100).

II.

ERNST FAILED TO INSTRUCT AND SUPERVISE ITS EMPLOYEES.

A leading case on public accountant's liability is the opinion of Judge Cardozo in *Ultramares* v. *Touche,* 255 N. Y. 170, 174 N.E. 441 (1931) holding that a public accountant could not be held liable for mere negligence by parties not in privity but could be held liable for damage to them by "gross" negligence which might be equivalent to fraudulent misrepresentation. "Fraud includes the pretense of knowledge when knowledge there is none", Judge Cardozo said, "Negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross." Then after citing a case[4] holding that an action for deceit would not lie against the president of a company for furnishing a false financial statement, if the defendant had no *scienter* because he believed the statement furnished by him to be true, Judge Cardozo said, "No such charity of construction exonerates accountants, who by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries". We suggest that any fair man would agree with Judge Cardozo's distinction: a Public Accountant should not be held liable to the public "for a thoughtless slip or blunder" but should be held liable to persons damaged by his certification made in gross violation of the canons of his profession. That is what we have in this case.

A few years after *Ultramares,* the Court of Appeals in New York applied the doctrine of that case in *State*

[4] *Kountze* v. *Kennedy,* 147 N. Y. 124 (1895).

Street Trust Co. v. *Alwin C. Ernst*[5] and another, co-partners doing business as Ernst & Ernst, 278 N. Y. 104, 15 N.E.2d 416 (1938). A client of Ernst loaned money on the inventories and receivables of merchants. To enable the client to borrow money, Ernst certified on several copies of its audit: "It is our opinion that the above condensed statement shows the financial condition of the company at the date stated." Relying on this certificate, the plaintiff bank loaned money to the company and, when it went bankrupt a year later, brought this suit against Ernst. The trial court set aside a jury verdict against Ernst and gave judgment for it. The Court of Appeals reversed. As in the case at bar, Ernst admitted that its client was deliberately dishonest. It had made uncollectible accounts appear good by having a company that it owned make payments on them.

Following Judge Cardozo's rule, the Court of Appeals said:

> "Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all suffi-

[5] The defendant in this case, Alwin C. Ernst, is listed on page 177 of Vol. II of *Who Was Who in America.* There he states that he founded the firm of Ernst & Ernst in 1903. On his death in 1948, according to *Who Was Who,* it had 46 offices in the United States and one in Canada. Today it has 113 offices in the United States and 10 in Canada, more than any other public accounting firm. It has opened more than two new offices a year every year since Ernst's death. Such rapid expansion gives it a problem in the recruitment, training, education, and supervision of its employees.

> cient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention." (15 N.E. 2d at 418-9)

In the case at bar, Ernst paid no heed to the laws of its profession regarding internal accounting control.

Throughout its brief, Ernst reiterates again and again that plaintiffs do not allege or charge it with heedless or reckless conduct, thus recognizing its liability for such conduct within the *Ultramares* rule of Judge Cardozo. It is true that the complaint does not contain the words "heedless" or "reckless". Neither does it contain the word, "negligence." It charges that Ernst breached its duty to review the internal accounting control. It charges that Ernst breached its duty to discover and report Nay's mail rule and the fact that he did not take regular vacations. It charges that by these breaches of its duty Ernst aided and abetted Nay's violation of Section 10 and Rule 10b-5. It does not mention Section 17(a).

However, in response to Ernst's Interrogatory 64, Plaintiffs stated that their counsel had been informed by a former president of the American Institute of Certified Public Accountants and by several other public accountants that it was "inexcusable negligence" for an auditor not to discover Nay's mail rule. By Ernst's Interrogatory 74, plaintiffs were asked what they claimed to be Ernst's motive in aiding and abetting Nay's fraud. They answered that they did not accuse Ernst of intentional fraud but stated: "With inexcusable negligence"

Ernst "took money for certifying a condition contrary to the facts and failing to report irregularities, known to it, or which should have been discovered by it, its report of which would have led to the discovery of Nay's fraud." We suggest that "inexcusable negligence" is equivalent to "gross negligence" or "heedless" or "reckless" conduct and, if necessary, we are entitled now to amend the complaint to use all of these words. *Elder* v. *Brannan,* 341 U. S. 277, 289 (1951).

In this case, Ernst & Ernst was grossly negligent in failing to instruct and supervise its employee, Jerry Hooker, on the elementary rules and laws of internal accounting control.[6]

He had no proper conception of internal accounting control (A 136) and stated that he had no objection to Nay's mail rule (A 211), which he said was not relevant to internal accounting control (A 105). Even his seniors at Ernst would not support Hooker in that position (A 135-140).

By Interrogatory 64, Ernst asked whether anyone ever informed plaintiffs that First Securities Company had inadequate internal accounting control under Nay's mail rule. The plaintiffs answered "Our counsel were informed in 1968 by Edward Byers Wilcox, former President of The American Institute of Certified Public Accountants

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[6] In its Release No. 160 of August 27, 1974, 4 CCH Sec. Law Rep. ¶72182, the SEC suspended an accounting firm from practicing before it for 18 months because "The accountant conducting it [a broker's audit] lacked adequate training and proficiency as an auditor and was not properly supervised by respondents. In addition, respondents failed to evaluate the effectiveness of the broker dealer's existing internal control."

(See *Who's Who in America*) that it was inexcusable negligence for an auditor of a securities dealer to fail to discover these facts since such a securities dealer had no internal control whatever under these facts. Our counsel has since discussed the matter with several certified public accountants, all of whom have confirmed Mr. Wilcox's statement." To the same effect as Mr. Wilcox's statement, plaintiffs filed the affidavits of Fred J. Duncombe, a former President of the Illinois Society of Certified Public Accountants and a former member of the Board of Examiners for certifying Public Accountants, who said that he would not have certified the statement of a broker whose president enforced Nay's mail rule since such company lacked internal accounting control. To the same effect, the plaintiffs also filed the affidavit of Gerhard Mayer, a CPA of 30 years standing (A 172-176).

Furthermore, this fundamental rule of internal accounting control is established by the testimony of 12 leading public accountants published by the SEC in 1939 *In the Matter of McKesson & Robbins, Inc.* McKesson & Robbins, a multi-million dollar concern whose securities were listed on the N. Y. Stock Exchange had as its president an ex-convict who, under a fictitious name, operated the company with the aid of his three brothers, also under fictitious names. They inflated the sales and inventories by many millions. They never took vacations except for a few days and one of them opened all the incoming mail, thus concealing their fraud. McKesson's audits had been certified by a nationally known Public Accounting firm. Like Nay, the president shot himself when his colossal fraud was discovered.

In its report (SEC Accounting Release No. 68, December 5, 1940, CCH Fed. Sec. Law Rep. 72027-72037), the

SEC said: ". . . the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. . . . the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized . . . The time has long passed if it ever existed when the basis of an audit was restricted to the material appearing on the books and records." Hooker's concept of internal control was practically limited to such records. He had no concept whatever of the necessary duality in internal control (A. 185-6). Apparently Ernst never told him about *McKesson*. He said he would not have objected to Nay's mail rule if he had known of it (A 211).

The SEC's report in *McKesson* included a complete transcript of the testimony before it of 12 leading American public accountants. Each of them was asked to define internal accounting control. A typical answer was that of Dr. Joseph J. Klein, Professor of Accounting and Public Accountant. He testified: "In general, the expression 'internal check and control' relates to a subdivision of duties and responsibilities among employees so as to minimize the opportunity for theft, speculation, falsification of records, and commission of errors by requiring collusion among at least two persons for the perpetration of crime or double errors to escape detection of such errors." (SEC McKesson & Robbins Report, Testimony of Expert Witnesses p. 490). Substantially, this same specification of duality as the essence of internal control was given by all the other expert witnesses. See, for example, Professor Hiram T. Scoville, p. 444, George D. Bailey of Ernst & Ernst, p. 549, Charles W. Jones of Arthur Anderson, p. 594, Charles Oliver Wellington of Scoville Wellington & Co., p. 73.

Victor H. Stempf of Touche, Niven & Co. (p 130) quoted a bulletin of the National Association of Cost Accountants: "Internal Audit Control may be defined as the arrangement of routine whereby the work of each employee is counterchecked by the work of another employee."

William H. Bell, a member for 30 years of Haskins & Sells, testified (p. 181) "A system of internal check and control means essentially that organization and routine are so divided that there is such a division of duties that no one person can profit by falsification of records and that any considerable error or fraud perpetrated by one person will be discovered by another".

Norman J. Lenhart of Lybrand, Ross Brothers & Montgomery testified: (p. 233). "The basic feature of a good system of internal check and control is that two or more persons must be involved in order for there to be any material error or fraud."

Under the *McKesson* facts, one of the criminals opened all of the incoming mail and the SEC then turned to the Public Accountant's duty on that subject. Each of the expert accountants testified that a Public Accountant must check his client's routine of handling incoming mail. (SEC McKesson & Robbins Report, Testimony of Expert Witnesses, pp. 30, 85, 143, 192, 243, 290, 340, 401, 455, 505, 558, 602). Each of the witnesses was shown a pamphlet published by the American Institute of Public Accountants entitled "Examination of Financial Statements by Independent Public Accountants." The attention of each witness was then called to a section in the pamphlet entitled "Safeguards surrounding the handling of incoming mail". Each of them testified that the routine of handling the incoming mail must be checked by the Independent Public

Accountant and found to be controlled. Under Nay's mail rule, the handling of incoming mail was completely uncontrolled.

Public accountants use the word "control" in a similar sense to its use by research scientists. A young scientist reports to his senior an experiment that indicates his discovery of a new principle. The old scientist says to him "but where is your control." In other words, where is your parallel experiment which proves that your result is attributable to the factors that you claim establish your discovery. (See Oxford and Century Dictionaries s. v. control.) "Control" as a noun was used in this sense of duality as early as 1750 in the first edition of Samuel Johnson's dictionary: "Control n. A register or account kept by another officer, that each may be examined by the other."

Professor of Accounting William T. Scoville was asked (p. 455) "To what extent must the accountant go in satisfying himself that these safeguards [on handling incoming mail] exist." He answered "I think the best would be to inquire into the procedure and see that the internal check exists . . . ." Under Nay's mail rule the internal check did not exist.

George D. Bailey of Ernst & Ernst was shown the American Institute of Accountant's pamphlet and asked (p. 558):

> "Q. Now at page 8 and again at page 24 under Accounts Receivable, reference is made to safeguards surrounding the handling of incoming mail and remittances and to the mailing of monthly statements to customers. In this connection, what inquiries or tests do you make?

A. Well, I would say actual observation and inspection and inquiries.
Q. Of all three stages?
A. Yes."

It is a pity that Ernst did not communicate this rule to its employee, Jerry Hooker, in the ten years that he worked on its First Securities Company audit. It is clear why his seniors would not support him in his statement that Nay's mail rule was not relevant to internal accounting control and that he would not have objected to it if he had known it (A 135-140). Hooker first worked on that audit in 1957 the year before he graduated from college (A 241). He became a CPA five years later in 1962 (A 180). *McKesson* occurred about the time that Jerry Hooker was born but Ernst apparently did not tell him about it.

Nay's mail rule was the heart and core of his fraud. On his suicide, the receiver found, locked in his desk, an immense mass of his correspondence with his escrow victims, much of which was introduced in the receivership case, *SEC* v. *First Securities Co.*, 463 F.2d 481 (1972). No securities transaction would be safe if a broker were allowed to conceal correspondence with his customers in that manner. Nay could only do this through his "adamant" mail rule.

Thus *In Matter of Bond & Goodwin, Inc.*, 1944, 15 SEC Reports 584, the SEC, after lengthy hearings, found a broker guilty of violations of the 1934 Securities Act for permitting the same practice regarding mail that Nay enforced. The opinion states: "The routine of respondent's office appears to have been very lax. Incoming correspondence dealing with the firm's business, when directed to a particular employee's attention would be forwarded to the employee without being opened . . . The great bulk of it [this correspondence] reposed in Davis' desk drawer . . ." (p. 599)

The opinion then states: "In the case now before us, respondent's purported rules appear to have been grossly inadequate, and the failure to enforce even these rules indicates culpable negligence." (p. 601)

The opinion indicated that the SEC would revoke respondent's license and expel it from the NASD except for the fact that the respondent had a large business which it had conducted for many years and the case disclosed fraud on the part of only one salesman out of many. The Commission concluded: ". . . we find it necessary in the public interest and for the protection of investors, and to carry out the provisions of Section 15 A [of the Act] to suspend respndent from the NASD for a period of thirty days." (p. 602)

Again, in the case of *In Re Kamen & Company*, SEC Release No. 7965, September 29, 1966, 4 CCH Fed. Sec. Law Rep. ¶77409), the SEC suspended a broker from the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers for tolerating Nay's practice regarding incoming mail. The broker had in his employ two salesmen who developed a great volume of listed stock business from over-the-counter dealers by instructing them to buy stock in a dummy corporation and simultaneously sell it at a fractional increase in price to another broker on a prearranged sale, thus rebating one quarter of Kamen's commissions on listed securities sales from the over-the-counter dealers. Kamen had no knowledge of this fraud of his employes. But the SEC opinion said: "It was the practice, in the firm, that mail addressed to or for the

attention of one of the registered representatives, or which from the envelope could be identified as coming from an account of a registered representative, would be given unopened to that representative. . . However, no procedures were established to review such correspondence." For tolerating this procedure, Kamen was suspended from the Exchanges and the NASD.

Following the *Kamen* case the Broker-Dealer Advisory Committee to the SEC in its Guide to Broker-Dealer Compliance stated (Ch. IV p. 60): "No personal mail should be permitted in an office or any letters distributed unopened to salesmen or other office employees."

NAY'S VACATIONS

Another egregious breach of Ernst's duties to review the internal accounting control was its lack of any inquiry as to Nay's vacations. Each year, Ernst, in accepting employment undertook that its report to the Midwest Stock Exchange would state that its examination included a review of the internal accounting control. And each year Ernst reported to Midwest Stock Exchange that its examination, upon which its certification was based, had included a review of the internal accounting control. (A181, 182, 185, 186, 187, 188, 189, 190, 197, 201, 202, 203). Ernst made no such review. Hooker admitted that "It is standard auditing practice to inquire whether employees take regular vacations." (A. 199). But Hooker apparently had no notion of the reason for this question.

The standard procedure of the Comptroller of the Currency, in examining national banks as to vacations, reveals Ernst's heedless and reckless inadequacy on vacations. The plaintiffs filed in this case the affidavit of Michael K. Garst, who had just retired after 25

years as a national bank examiner. Attached to his affidavit is the printed copy of the Comptroller's 92 questions on internal control. (A170-171) Each examiner must answer yes or no to each question. The necessity of duality of control, as testified to by the 12 expert public accountants in the *McKesson* case is plainly apparent from these questions. Ernst had no checklist whatever on internal control. Such a checklist would have been contrary to Ernst's policy of ingratiating itself with its clients. Its seniors, managers or partners back at the office thus received from its field men no report for review on internal control. Ernst's annual certification that it had reviewed the internal accounting control was simply not true.

Question R1 of the Comptroller of the Currency's checklist is: "Are all Officers and employees required to be absent from the bank at least two consecutive weeks annually?" (A168) Garst's affidavit stated that this "was an important question because the essence of Internal Controls is duality of control. The rule requiring two weeks' absence from the bank is to assure such duality."

The Comptroller of the Currency's procedure on this subject is shown by the Bank Administration Manual, a two volume work, issued annually by the Bank Administration Institute, at Volume I pages 479-480 as follows:

> "VACATION POLICY
>
> An uninterrupted vacation of two consecutive weeks away from the bank premises provides a simple yet effective internal control. The individual officer and employee will be physically and mentally refreshed by an enforced absence from daily labors. And during that period most transactions in process will clear, and exceptions can be investigated.

"It is important that the vacationing employee stay away from the bank premises. Obviously a person who has access to bank records while he is on vacation can still continue to manipulate them. Frauds have even been carried on by employees who, while supposedly on vacation, waited in the lobby for certain customers.

If a payday falls within the vacation period, pay the salary when the person leaves on vacation, or arrange to deposit his pay so that there is no reason for anyone to return to the bank for his salary.

It is the auditor's responsibility to make certain that every officer and employee has taken the prescribed vacation. The auditor should include in his report to the board of directors an annual summary of vacations, noting any exceptions. As a simple enforcement of the mandatory vacation policy, require each officer and employee to sign a statement that he took a vacation and was away from the bank during a specified period. To avoid the possibility of false statements, each form should be countersigned by his supervisor or another person.

In accordance with bank policy, I have had a minimum of two consecutive weeks vacation this year, and did not return to the bank during that time. My vacation started on ..... and I returned on ..... .

The only exception to this statement was:

.....

.....

.....

SIGNED .....

I verify that the person named above was actually away from the bank for the period stated.

VERIFIED .....

NOTE: Complete this form on the day returning from vacation. Return the completed form to ..... for use of the board of directors and supervisory examiners.

While an employee is on vacation, the work he normally handles should be assigned to someone else. If the work is allowed to accumulate until the person returns, the control will not be effective. Employees in areas of exposure—for example, teller and bookkeepers—should be encouraged to take vacations over critical periods such as statement preparation time or the end of the month. The auditor then has an opportunity to check the vacationing person's work independently without influence of explanation from him. Any exceptions in work processed by the person can be investigated."

The fecklessness and ineffectiveness of Ernst's procedure on vacations appears in the examination of Mr. Hooker. He reported to his office: "Vacations are taken regularly by all employees and the duties of the employees are performed by others in their absence" (A 186). Hooker had been given the impression: interior control is an empty formality—all the public accountant has to do is to note on his report that vacations are taken regularly. This was a mistake that cost the plaintiffs dearly. He testified that vacations are "an element of internal control" (A 198) but he said that Ernst had no instructions that required this inquiry. (A 190). He did not know whether there was any record of any inquiry about vacations in his working papers (A 199). But he agreed that it was standard procedure to ascertain whether employees took regular vacations. He did not know whether any inquiry was made on whether Nay had taken regular vacations (A 200). He was asked: "If you had made an inquiry and discovered that he did not take regular vacations, that would have been a red flag of warning, would it not?" Ernst's attorney instructed him not to answer and he refused (A 200). He was asked: "Do you customarily ask to see the vacation schedule in a brokerage audit?" And he answered: "I don't believe we

customarily ask to see the vacation schedule, although we have to inquire about vacations as when they are doing the audit on a surprise basis to schedule our surprise audit at a time when the key people are there" (A 200). Q. "You merely ask the office manager if the employees take regular vacations and he says, Yes. Isn't that true?" A. "Generally that coupled with what I have said about scheduling our audit."

That was actually all that Ernst did on internal accounting control. We submit that a Public Accountant's duty to review the internal accounting control cannot be met by merely asking the office manager if the employees take vacations.

Ernst now demands a summary judgment on the basis of the affidavit of Roy Campbell, the office manager, that "Nay took vacations every year from 1946 to 1968. . . . First Securities did not maintain records showing dates and times of vacations of its officers." (A 96).

Clearly, no summary judgment can be granted on that affidavit. Campbell does not state that Nay was absent for any consecutive number of days. He does not state that Nay did not return to the office to get his unopened mail piled up on his desk during any vacation. He does not state that Nay took "regular" vacations. And the issue here is whether Ernst performed its professional duty to review the internal accounting control and not the extent of Nay's vacations.

In response to Ernst's Interrogatory 42, the Plaintiff, Agnes Smith, stated "Nay's vacations were short and plans often changed or postponed." He could not be absent from the office when his colossal fraud might be discovered. To the same interrogatory, the plaintiff, Helen Allison, stated, "Mrs. Nay often complained that

her husband would not take regular vacations. Plans would be made and cancelled. This was common knowledge among her friends and acquaintances. She would tell me as we met for a chat on the street or as we saw each other at a board meeting or lecture. Common friends would discuss it. This went on over the years."

Campbell's testimony, when he was examined by receiver's counsel in the receivership of First Securities Company, gives quite a different impression than his affidavit for summary judgment drawn by Ernst's attorneys. He testified (pages 737-8), as shown by plaintiff's answer to Ernst's Interrogatory 44.

> "Q. Could you describe for us the procedure in the office of First Securities Company of Chicago during the time of your employment regarding the handling of any mail that was either addressed to Mr. Nay or addressed to the company to his attention?
>
> A. He was very adamant that all mail addressed in that manner came to him personally unopened.
>
> Q. How was it handled during the time that he was out of town on vacation or on trips?
>
> A. When he was either out of town or on vacation, a trip of any kind, he would leave word with his secretary, Mrs. Ryan, to gather all of his mail as it came in. He would make calls to the office periodically while he was away, and ask who the envelopes were from. He would either tell her to hold them unopened until he returned, or mail them out to his house so he could see them when he got back from his vacation or trip.
>
> Q. Was there an occasion that you opened a piece of mail of that nature without his advance approval?
>
> A. Yes, I recall once when I had a very good idea of what it was. We had sold some securities for a client whom I believe lived in Colorado, and we had calls from the broker through whom they were sold. They were late getting it. Mr. Nay was out of

town, and I saw the envelope come in from this party, and knowing or having a very good idea of what was in it, I opened it, and there was a stock certificate that had been sold, and I went ahead and delivered it to the buying broker, and when I told Mr. Nay about this on his return, I got chewed out about it.

Q. Did you repeat such an occurrence thereafter?

A. I did not."

He also testified (as shown by the response to Ernst Interrogatory 57.)

"Q. Did you ever tell the representatives of Ernst & Ernst that no one but Nay was permitted to open mail addressed to the company in his attention?

A. No. I don't recall that I did.

Q. And did Ernst & Ernst ever ask you about the routine of restricting the opening of mail?

A. No. I do not believe they ever did.

Q. They never asked any question of you which would require the divulgence by you that you were under the restriction of not opening mail addressed to the company to the attention of Nay?

A. No, they did not."

Ernst's failure to make any inquiries on internal accounting control regarding Nay's vacations cannot be met by Campbell's affidavit for summary judgment that "Nay took vacations" each year. That is a factual issue.

Furthermore, as this Court held in *Sartor* v. *Arkansas Natural Gas Corporation,* 321 U.S. 620, 627, 1944, and in *Adickes* v. *Kress & Co.,* 398 U. S. 144, 176, 1970, no summary judgment can be granted on the basis of Campbell's affidavit (contradicted by two of the plaintiffs) because plaintiffs are entitled to cross examine him.

III.

SCIENTER IS A JURY ISSUE AND IS NOT PERTINENT TO A MOTION FOR SUMMARY JUDGMENT.

Throughout its brief, Ernst demands that this Court grant it a summary judgment because the plaintiffs have not proved *"scienter"*. But that is a criminal law term. We suggest that this Court has defined that word in a way that makes it peculiarly inapplicable on Ernst's demand for summary judgment. In *Morissette* v. *United States,* 342 U.S. 246 (1952), the defendant was indicted for picking up some exploded bomb casings on a large government aviation target range and selling them as junk. He said he believed they had been abandoned. The District Court directed a verdict against him because, the court said, the defendant could not have believed the shells had been abandoned on government land. This Court reversed, holding that "scienter" is always a jury question.

Justice Jackson, speaking for a unanimous Court, reviewed the history of criminal intent, and *"scienter"* (Emphasis supplied). He pointed out that in modern times the "wide distribution of goods became an instrument of wide distribution of harm." Hence, he said, ". . . those who dispersed food, drink, drugs and even *securities* did not comply with reasonable standards of quality, integrity, disclosure and care" (p. 254, Emphasis supplied). He spoke of "administrative regulations" to meet this situation and said "many of these offenses are . . . in the nature of neglect where the law requires care, or inaction where it imposes a duty." (p. 255) "Hence, legislation applicable to such offenses, as a matter of policy, does not specify intent as a necessary element." (p. 256)

Justice Jackson quoted (p. 258) Chief Justice Taft in *United States* v. *Balint,* 258 U.S. 250 (1922), a drug case:

> "While the general rule at common law was that the *scienter* was a necessary element in the indictment and proof of every crime, and this was followed in regard to statutory crimes even where the statutory definition did not in terms include it . . ., there has been a modification of this view in respect to prosecutions under statutes the purpose of which would be obstructed by such a requirement."

Justice Jackson said: "In the civil tort, except for recovery of exemplary damages, the defendant's knowledge, intent, motive, mistake, and good faith are generally irrelevant." (p. 270).

And he concluded: ". . . the question of intent can never be ruled as a question of law, but must always be submitted to the jury." (p. 274).

Furthermore, *Ultramares,* the leading case on the subject of Public Accountants' liability, specifically repudiates *scienter* as a possible defense to a Public Accountant guilty of gross negligence. Distinguishing a case where lack of *scienter* had been held a defense, Judge Cardozo said, "No such charity of construction exonerates accountants who by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries." (174 N.E. at 449).

Thus, no summary judgment can be granted to Ernst for lack of proof of scienter.

IV.

ESTOPPEL IS A FACTUAL ISSUE.

This Court has never granted a summary judgment on the basis of estoppel. Under its prior decisions, the party

claiming a summary judgment on that basis would have to produce a document conclusive *per se.* As the Court of Appeals held in this case, no summary judgments could be granted on the basis of the confirmations of account signed by six of the seventeen plaintiffs. (503 F.2d 1100, 1116-7.) That is a factual issue.

Take the confirmation signed by Theresa W. Rothermel (503 F.2d at 1116). First Securities Company said to her: "We would appreciate your verifying the position of the securities and the balance in your account as shown below." The only item shown below is "10M U.S. Treasury Bills 1/11/68". Theresa W. Rothermel signed under the words, "The above statement of my (our) account is correct."

By this confirmation, Mrs. Rothermel confirmed that on October 31, 1967 First Securities Company was holding $10,000 U.S. Treasury Bills for her account. Fourteen years before in 1953 Nay had sold her the fraudulent escrow and had delivered to her the security. He had purported to pay interest on it for the 14 years. She knew nothing about Nay's fraud on October 31, 1967 when she signed this confirmation. She did not learn of his fraud until his suicide in June 1968. Clearly, no language of this confirmation related to a purported security that Nay had sold her 14 years before, any more than it related to any other security that she might have bought from First Securities Company through the years. On delivery of the securities to her, these were closed transactions which could not appear as a liability of First Securities Company until Nay's fraud was discovered. By this confirmation of the $10,000 U.S. Government Bills which First Securities Company held for her, Mrs. Rothermel did not represent anything regarding the escrow. She had no reason to do so. How could this confirmation of her account be a repre-

sentation to Ernst of anything except what appears on it, viz., that First Securities Company held $10,000 in U.S. Bills belonging to her? Ernst alleges (A. 25) that her failure to inform Ernst of her escrow claim on this confirmation estops her from suing for the gross negligence of Ernst when a year later she discovered Nay's fraud. Ernst had facilities to discover it which she did not have.

Anyone receiving this request for confirmation would assume that he was requested to confirm the transaction stated thereon and not queried about all transactions that he might have had through the years.

Ernst argues that she misled it because in the confirmation of her current account she never mentioned the escrow. Ernst has produced no evidence that there was any occasion for her to do so before she discovered Nay's fraud. The confirmation was a statement of the amount due her on her current account and not confirmation of past completed transactions. We submit that there is no basis whatever for a summary judgment on estoppel by any document produced by Ernst in this case. Clearly the Court of Appeals was correct in the statement that the issue of estoppel is an issue of fact that precludes a summary judgment.

V.

STATUTE OF LIMITATIONS.

Ernst claims that it must be given a summary judgment because the three-year statute of limitations started to run from the completion of its last audit in 1967. But at that time the plaintiffs knew nothing about Nay's fraud. They did not learn of it until his suicide in June, 1968. These suits were filed within three years from that date.

Ernst reiterates again and again that there is a Federal rule requiring "fraudulent concealment" in order to stay the running of the statute of limitations in fraud cases. On the contrary the decisions of this Court specifically reject the doctrine of "fraudulent concealment" as a necessary factor to toll the statute. The rule of this Court is that, unless there is negligence or laches on the plaintiff's part, the statute "does not begin to run until the fraud is discovered." The great leading case is *Bailey* v. *Glover*, 88 U.S. 342 (1874). Glover rather than pay a debt he owed conveyed all his property to his wife, father-in-law and son and filed a bankruptcy petition. After the statute had run, the assignee in bankruptcy learned of the fraudulent conveyances and brought this action to set them aside. In an opinion by Justice Samuel Miller this Court established the federal doctrine that a cause of action based on fraud accrues for the purposes of the statute of limitations upon discovery of the fraud. Glover argued that he had not concealed the fraud, but this Court repudiated concealment as a significant factor, holding that no active concealment of fraud is required to suspend the running of the statute of limitations. This Court said:

> ". . . The bar of the statute does not begin to run until the fraud is discovered, *though there be no* special circumstances or *efforts on the part of the party committing the fraud to conceal it* from the knowledge of the other party." 88 U.S. at 348 (Emphasis supplied)

This statement is quoted as the controlling rule by Justice Frankfurter in *Holmberg* v. *Armbrecht*, 327 U.S. at 397 (1946).

From *Bailey* emerges the clear and unquestioned rule that controls the limitation period in actions based on fraud:

> ". . . We hold that where there has been no negligence or laches on the part of a plaintiff in coming to the knowledge of the fraud *which is the foundation of the suit,* and when the fraud has been concealed, *or is of such character as to conceal itself,* the statute does not begin to run unil the fraud is discovered by, or becomes known to, the party suing, or those in privity with him." 88 U.S. at 349-350. (Emphasis supplied.)

Contrary to the Federal rule, some states have a rule that the running of the statute is suspended only when the fraud has been actively concealed. Thus in *Janigan* v. *Taylor,* 344 F.2d 781 (1st Cir. 1965), *cert. den.* 382 U.S. 879, the court refused to apply in a 10b-5 action the Massachusetts rule requiring active concealment on the part of the defendant. The court said:

> "Federal law has long been established with more liberality than that of Massachusetts, that *where fraud is involved the cause of action is, so-to-speak, automatically concealed and does not arise until discovery. Bailey* v. *Glover,* 1875, 21 Wall. 342, 22 L.Ed. 636, *Traer* v. *Clews,* 1885, 115 U.S. 528, 6 S.Ct. 155, 29 L.Ed. 467." 344 F.2d at 784. (Emphasis supplied.)

Of course whether the plaintiffs were guilty of any negligence or laches in failing to discover Nay's fraud is wholly a question of fact and cannot be disposed of on motion for summary judgment.

Thus, in *Azalea Meats, Inc.* v. *Muscat,* 386 F.2d 5, 9-10, (5th Cir., 1967) the court reversed and remanded a summary judgment for defendants which was granted on the ground that the plaintiff had failed to exercise due diligence to discover the alleged fraud. In so doing the court observed:

> "The concept of due diligence is not imprisoned within the frame of a rigid standard; it is protean in

> application. A fraud which is flagrant and widely publicized may require the defrauded party to make immediate inquiry. On the other hand, one artfully concealed or convincingly practiced upon its victims may justify much greater inactivity." 386 F.2d at 9.

The Court further noted that the factual issue of due diligence requires an assessment of the state of mind of the plaintiffs, a task incapable of resolution on motion for summary judgment. The court echoed Judge Hutcheson in *Alabama Great Southern R. R. Co.* v. *Louisville and Nashville R. R.,* 224 F.2d 1 (5th Cir., 1955):

> ". . . where motive, intent, subjective feelings and reactions, consciousness and conscience were to be searched, an examination and cross-examination were necessary instruments in obtaining the truth. . . . [thus] the issues may not be disposed of on summary judgment." 386 F.2d at 10.

In *United States* v. *Diamond Coal & Coke Company,* 255 U.S. 323, 1921, this Court reversed a holding by the 8th Circuit Court of Appeals, made on motion to dismiss, that the statute of limitations had run on a suit to set aside fraudulent land patents made 14 to 21 years previously. Chief Justice White speaking for a unanimous court said, ". . . we are of opinion that error was committed in disposing of the Bill upon the motion to dismiss, and that the ends of justice require that it should be only finally disposed of after hearing and proof. . . ." (p. 335)

Clearly the Court of Appeals correctly held in the case at bar that Ernst could not be given a summary judgment on the statute of limitations.

CONCLUSION

Confidently we submit that no summary judgment can be granted to Ernst & Ernst in this case.

Respectfully submitted,

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